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IN THE

Supreme Court of the United States

OCTOBER TERM, 1943.

No. 416

M. W. ALWORTH AND R. D. ALWORTH, AS TRUSTEES UNDER THE LAST WILL AND TESTAMENT OF M. H. ALWORTH, DECEASED,
Petitioners,

vs.

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE CIRCUIT COURT OF APPEALS FOR THE EIGHTH CIRCUIT AND BRIEF IN SUPPORT THEREOF

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vs.

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE, *Respondent.*

PETITION FOR WRIT OF CERTIORARI

Your petitioners respectfully represent:

That they are aggrieved by the judgment of the Circuit Court of Appeals, for the Eighth Circuit, rendered July 12, 1943 (136 Fed. (2d) 812), holding that your petitioners are subject to a deficiency Federal income tax for the calendar year 1937, as theretofore determined by the Commissioner of Internal Revenue, thereby reversing the decision of the Board of Tax Appeals (now Tax Court of the United States) entered June 10, 1942 (46 B. T. A. 1045), to the effect that your petitioners are not subject to such deficiency tax.

A.

SUMMARY STATEMENT OF THE MATTER INVOLVED

The petitioners are testamentary trustees under the will of M. H. Alworth, deceased. During the year 1937, they were the owners of 3/10ths of the outstanding capital stock

of Royal Mineral Association, a Minnesota corporation, which was organized about 1909 and liquidated near the end of 1939. Throughout its existence, that corporation owned certain mineral lands in Minnesota. Its income consisted of royalties paid for iron ore mined and removed under leases of said properties. In each year of its existence, it distributed to its stockholders all of its net earnings for the year and substantial amounts from depletion reserves on account of such ore so mined and removed. As a consequence, it never carried over from one year to another any earned surplus. In 1917, and each year thereafter, the net taxable income of the corporation, less Federal income taxes accrued for such year, was regarded as the portion of such distributions which constituted taxable dividends when received by the stockholders, the remainder being regarded as depletion or return of capital. There is no evidence that the Commissioner ever disputed the propriety or the accuracy of that method of determining taxable income so received by the stockholders, nor is there any evidence as to how such income of the stockholders was computed or determined prior to the year 1917.

The corporation's taxable net income for the year 1937 was $464,033.94. The Federal income tax on that amount was $92,552.88, which was paid in 1938. Pursuant to such long continued practice, the petitioners computed their 1937 Federal income tax by deducting from the corporation's taxable income for that year the Federal income tax accrued thereon and returned as taxable dividends their pro rata share of the balance, as follows:

Net income of corporation	$464,033.94
Less accrued Federal income tax thereon for the year 1937, payable in 1938	92,552.88
Balance of net income or profit distributed to stockholders	$371,481.06

Petitioners thereupon returned as taxable income their pro rata share as stockholders of such $371,481.06.

Thereupon, the Commissioner departed from the long-established method above described and refused to allow the trustees, in computing their own income for that year, to deduct from the corporation's net taxable income any part of its accrued but unpaid income tax, and proceeded to determine their income as follows:

Net income of corporation	$464,033.94
Less Federal income tax paid by corporation in 1937 on its 1936 income	30,606.76
Balance of net income or profit distributed to stockholders	$433,427.18

By this change, the Commissioner undertook to add $61,946.12 to the amount which the dividend-receiving stockholders of Royal Mineral Association were required to treat as income to them of the corporate distributions of the year. The trustees' pro rata share of that increase amounted to $18,534.36 and their individual income tax was thereby increased $5,289.66. The above recited facts are stated in the findings of the Board of Tax Appeals on page 10 of the Record, and in the opinion of the lower Court on page 24 of the Record. The Board of Tax Appeals, on petition for review, reversed the determination of the Commissioner and approved the original computations of the taxpayers. The Circuit Court of Appeals reversed the Board of Tax Appeals, and affirmed the decision of the Commissioner (136 Fed. (2d) 812). The matter is now before this Court on this Petition for a Writ of Certiorari.

B.

JURISDICTION

The basis upon which it is contended that this Court has jurisdiction to review the decision of the Court of Appeals is Section 347 of the Judicial Code (Title 28, Section 347, Federal Code Annotated), which provides:

> "In any case, civil or criminal, in the Circuit Court of Appeals * * * it shall be competent for the Supreme Court of the United States, upon the petition of any party thereto * * * to require by certiorari * * * that the cause be certified to the Supreme Court for determination by it with the same power and authority and with like effect as if the cause had been brought there by unrestricted appeal."

C.

THE QUESTION INVOLVED

Section 22 (a) of the Revenue Act of 1936 defines "gross income" for income tax purposes, and provides that it includes "dividends." Section 115 (a) defines "dividend" (for the purpose of this case) as "any distribution made by a corporation to its stockholders * * * out of earnings or profits of the taxable year." These and other sections of the Act are included in an appendix to Petitioners' Brief hereto attached. The question here involved requires a construction and application of those provisions and may be stated briefly and in condensed form as follows.

Whether, a corporation having distributed to its stockholders in any year all of its taxable earnings of that year, a stockholder may, in making his own personal Federal income tax return, deduct from the taxable income of the corporation for the year the Federal income tax accrued on that income, payable in the following year, in order to deter-

mine the amount of such distributions received by him which constitute taxable income to him. The problem is one of determining the actual earnings or profits received by the stockholder within the meaning of said Section 22 (a).

It is admitted that income taxes of the corporation in this case should be deducted in computing the taxable income of the stockholders included in corporate distributions received by them. The corporation being on a cash basis, it is the Commissioner's contention that the income taxes of the corporation so deductible are only those *paid* during the year. It is the taxpayers' contention that the income taxes of the corporation so deductible are those *accrued,* even though not paid until due in the following year, such Federal income tax not being deductible by a corporation under any circumstances in making its income tax return. The question is who is right.

Stated otherwise, the question at issue is as stated by the Internal Revenue Agent in Charge at St. Paul, in a letter of May 12, 1939, to Mr. Frank W. Wilson (now deceased), who then represented these taxpayers, as follows:

> "The sole question relates to the determination of the taxable portion of distributions received by the above taxpayer from Royal Mineral Association of Duluth. More particularly, the question presented is whether the available earnings and profits of that Association, which keeps its books and files its income tax returns on the cash receipts and disbursements basis, should be reduced by accrued Federal income tax for the year 1937, amounting to $92,552.88, or by Federal income taxes paid during the year 1937 on its 1936 income, amounting to $30,606.76."

Deduction of State income taxes is not here involved.

D.

REASONS RELIED ON FOR THE ALLOWANCE OF THE WRIT

Importance of Question Involved.

There is involved in this proceeding a construction of vital provisions of the Federal Income Tax laws found in the Revenue Act above mentioned, to-wit, Section 22 (a) and Section 115 (a), which are still unchanged and now in force so far as affects the questions here under consideration.

Conflict of Decisions.

The decision of the lower Court is directly contrary to that of the Circuit Court of Appeals of the Second Circuit in *Hadden vs. Commissioner,* 49 Fed. (2d) 709, handed down in 1931. In that case, there was the same problem of determining how much of corporate distributions received by a stockholder from a corporation making its income tax return on the cash basis constituted taxable income to him, and the Court of Appeals of the Second Circuit said:

> "There appears to be no sound reason why the current earnings or profits should not first be reduced by the amount of the tentative tax in determining the amount of the current or post March 1, 1913, earnings available for distribution of dividend. *Commissioner of Int. Rev. vs. James* (C. C. A. 2), 49 Fed. (2d) 707, decided May 4, 1931."

It is of course very desirable that the correct interpretation of the statutes be laid down promptly so as to provide for uniform application throughout the country, and thus avoid confusion, litigation and conflicting decisions in different circuits. We believe the Court will find the decision under review clearly erroneous.

PRAYER FOR WRIT

WHEREFORE, your petitioners pray that a Writ of Certiorari be issued out of and under the seal of this honorable Court, directed to the Circuit Court of Appeals for the Eighth Circuit, commanding that Court to certify and to send to this Court for its review and determination, on a day certain to be therein named, a full and complete transcript of the Record and all proceedings in case numbered on its docket 12517 entitled, "Guy T. Helvering, Commissioner of Internal Revenue, Petitioner, vs. M. H. Alworth Trust, M. W. Alworth and R. D. Alworth, Trustees, Respondents," and that the judgment of said Circuit Court of Appeals be reversed by this Court, and that petitioners may have such other and further relief in the premises as to this honorable Court may seem meet and just.

Dated September 29th, 1943.

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vs.

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BRIEF IN SUPPORT OF PETITION FOR WRIT OF CERTIORARI

SUMMARY OF BRIEF

I. OPINIONS BELOW

II. STATEMENT OF THE CASE

III. THE QUESTION INVOLVED

IV. SPECIFICATION OF ERRORS

V. ARGUMENT

1. Authorities Sustain the Taxpayers' Contentions.
2. Regulations Issued by the Commissioner Sustain the Taxpayers' Contentions.
3. Reasons Supporting the Hadden Case.
4. The Commissioner's Position—Errors Therein.
5. Discussion of the Opinion of the Lower Court.

I.
OPINIONS

The findings and opinion of the Board of Tax Appeals are found beginning on page 10 of the Record.

The opinion of the Circuit Court of Appeals is found at page 24 of the Record.

II.
STATEMENT OF THE CASE

The case is as stated in the foregoing Petition for a Writ of Certiorari, and need not be here repeated.

III.
THE QUESTION INVOLVED

The question involved is also stated in the foregoing Petition.

IV.
SPECIFICATION OF ERRORS

1. The Circuit Court of Appeals erred in holding that the petitioners could not deduct the accrued 1937 Federal income tax of the Royal Mineral Association from its taxable income for that year and treat their pro rata share as stockholders of the balance only as earnings and profits included in the corporate distributions received by them.

2. The Court erred in holding that there is a deficiency in petitioners' income tax for 1937.

3. The Court erred in reversing the decision of the Board of Tax Appeals.

These assignments go to a single point and will be argued collectively.

Statutes and Regulations Involved.

The statutes and regulations involved are set out in the appendix hereto.

V.

ARGUMENT

1. Prior Decisions of This Court and of the Circuit Court of Appeals Fully Sustain the Taxpayers' Contention.

So far as we have been able to ascertain, there has been only one reported Court decision prior to this case involving directly the exact point at issue. That was the case of *Hadden vs. Commissioner,* 49 Fed. (2d) 709, handed down on May 11, 1931, by the Circuit Court of Appeals of the Second Circuit. That case involved the income of a stockholder included in corporate distributions received from a corporation making its return on the cash receipts and disbursements basis. In discussing the question, the Court said:

> "What must be determined is the amount of earnings and profits of the Coal Company which was available for distributions to stockholders on the date of the distributions. Since the earnings to each of these dates is unknown, the Commissioner is compelled to ascertain the earnings for the entire year and pro rate them. This would logically follow from the reasoning of the *United States vs. Anderson,* 269 U. S. 422, 46 S. Ct. 131, 70 L. Ed. 347. In applying Section 31 of the Revenue Act of 1916 (as added by Revenue Act of 1917, Sec. 1211), the court is concerned with ascertaining the amount of real earnings and profits which are available for distribution to stockholders on the date of each distribution.
>
> "There appears to be no sound reason why the current earnings or profits should not first be reduced by the amount of the tentative tax in determining the amount of the current or post March 1, 1913, earnings available for distribution of dividend. *Commissioner of Int. Rev. vs. James* (C. C. A. 2), 49 Fed. (2d) 707, decided May 4, 1931."

In *Fawcus Machine Company vs. U. S.,* 282 U. S. 375, 51 S. Ct. 144, 75 L. Ed. 397, this Court had under consideration

the determination of a corporation's invested capital. The question was between the Revenue Department and the corporation taxpayer; yet even as between those parties the Court said:

> "A corporation cannot claim to have accumulated any net income in any year until provision is made for taxes accrued based on net income for the same year."

In *Commissioner vs. James,* 49 Fed. (2d) 707, said Circuit Court of Appeals of the Second Circuit had for consideration the determination of the taxable income of a stockholder included in corporate distributions received by it from a corporation keeping its books and making its returns on the accrual basis, and the Court said:

> "As the Anderson case would indicate, the true income for the year 1918 could not have been determined without deducting from the corporation's gross income for the year the total costs and expenses attributable to the production of that income during that year, and a reserve for income taxes set up in the books for the year must be deducted from the gross profits for the year before net results of operation can be ascertained."

In no case, so far as we are informed, has any Court heretofore specifically recognized or suggested any distinction, so far as deduction of Federal income tax is concerned, between distributions received from a corporation on a cash basis and such distributions received from a corporation on the accrual basis when the income of the stockholder is to be determined. As we shall undertake to show later in this brief, there is no logical basis for any such distinction.

2. Regulations Issued by the Commissioner Himself Sustain the Taxpayers' Position.

In this argument, when we mention the Commissioner, we refer to the present Commissioner, his predecessor in office, or the Treasury Department, as the case may be.

With undoubtedly full understanding and appreciation of the intention of Congress, evidenced by the wording of the various statutes referred to, the Treasury Department in Regulations 62—Income Tax, promulgated under the similar Revenue Act of 1921, provided under the general title "Definitions and General Provisions" in Article 1542, as to what distributions by a corporation should be deemed to have been made from earnings and profits, as follows:

> "In ascertaining whether or not a distribution was made out of earnings or profits of the taxable year, there should first be set aside a proper reserve for the payment of accrued income and excess profits taxes."

We do not have regulations available from which we can say definitely when the use of that exact phraseology was discontinued. We can state, however, that there is nothing in the present regulations to the contrary.

The lower Court declined to follow the rule of the Hadden case on the stated ground of "lack of reasoning." The Court evidently gave little or no consideration to the fact that the Hadden case has stood as unquestioned judicial authority for a period of nearly twelve years. No request was even made for a review of it.

3. Reasons Supporting the Hadden Case.

In view of such reference to the fact that in the Hadden case, the Court, while evidently having considered the question carefully, apparently considered it unnecessary to dis-

cuss extensively the reasons for its decision, we shall here discuss reasons which may have entered into the consideration of that Court and which, regardless of that fact, justify the ruling thereby laid down and at the same time show the error of the Commissioner's present position.

Income Taxes Are Based on Actual Income.

It is provided in Section 22 (a) of the Revenue Act of 1936 that gross income shall include dividends received; and it is provided in Section 115 (a) of the Act that a "dividend * * * means any distribution made by a corporation out of earnings or profits." There is nothing in the statute providing how earnings and profits shall be computed. It is provided, however, in Section 41-1 of the Act that if the method of accounting followed by the taxpayer does not clearly reflect his income, then the computation thereof shall be made in such manner as, in the opinion of the Commissioner, does clearly reflect such income. In discussing this subject, as covered by the like 1916 Revenue Act, the Circuit Court of Appeals in the Hadden case used the following language:

> "The Court is concerned with ascertaining the amount of real earnings and profits which are available for distribution to stockholders on the date of each distribution."

In Article 41-3 of Treasury Regulations 94—Income Tax, issued under the Act of 1936, it is provided:

> "Each taxpayer is required by law to make a return of his true income."

This Court, in *United States vs. Anderson,* 269 U. S. 422, 46 S. Ct. 131, 70 L. Ed. 347, in discussing a similar question, said:

> "The Appellee's true income for 1916 could not have been determined without deducting from its gross income for the year the total cost and expenses attributable to the production of that income during the year."

To the same effect, see *McKinney vs. Commissioner of Internal Revenue* (C. C. A. 10), 87 Fed. (2d) 811; *Commissioner vs. James, supra; Fawcus vs. United States supra; Harder vs. Erwin,* 285 Fed. 402.

In the Revenue Laws Congress Used the Words "Earnings" and "Profits" in Their Natural, Ordinary and Commonly Understood Meaning.

In *Commissioner vs. F. J. Young Corporation,* 103 Fed. (2d) 137, the Circuit Court of Appeals of the Third Circuit, in a case arising under the Revenue Act of 1928 in all essential respects the same as the Revenue Act of 1936, in so far as this case is concerned, said:

> "Section 115 (a) is simply a definition of the word 'dividend' and merely distinguishes between a distribution out of 'earnings and profits' and a distribution out of capital. The words 'earnings or profits,' as used therein, are words in common use, and 'are to be given their natural, plain, ordinary, and commonly understood meaning.' 59 *C. J.*, p. 975, section 577; *Miller vs. Robertson,* 266 U. S. 243, 45 S. Ct. 73, 69 L. Ed. 265; *DeGanay vs. Lederer,* 250 U. S. 376, 39 S. Ct. 524, 63 L. Ed. 1042; *Lake County vs. Rollins,* 130 U. S. 662, 9 S. Ct. 651, 32 L. Ed. 1060."

The accuracy of these conclusions seems so obvious that we have made no search for other authorities.

The 1937 Actual Profits and Earnings of the Royal Mineral Association Can Only Be Accurately Ascertained by Deducting from the Corporation's Taxable Income the Tax Accrued Thereon.

Using the words "income and profits" in their natural and commonly understood meaning, the truth of the foregoing title is self-evident. If, for instance, the Royal Mineral Association had sent out a statement of earnings and profits for the year 1937, ignoring the fact of $92,552.88 accrued and unpaid income taxes thereon, stockholders and investors would have understood that to mean $92,552.88 after taxes, and any Court, if the occasion arose, would have held such statement to be fraudulent and would have held the corporation and its officers liable in damage to any investor who might have invested his money in the stock of the corporation on the strength of such statement and sustained a loss as the result thereof. Likewise, any creditor who extended credit to the corporation on the strength of such statement would have had a clear and definite cause of action on account of fraud if he had sustained damages because of having relied thereon.

If, upon liquidation of the corporation in 1939, it had disbursed to its stockholders all of its taxable income, retaining no property with which to pay those taxes in the following year, the Commissioner would have been the first to bring suit against the stockholders to recover from each of them his pro rata share of such distribution which represented the unpaid income tax on such corporate profits. He would have done so upon the ground that such receipts to the stockholders were, to the extent of the income tax unpaid, distributions of capital which the stockholder had no right to retain, either as income and profits or otherwise, and the Commissioner would have been perfectly right in

such proceeding.

The Commissioner would have proceeded under Section 311 of the Revenue Act of 1936, which provides in part as follows:

> "Section 311—Transferred Assets—The amounts of the following liabilities shall, except as hereinafter in this section provided, be assessed, collected and paid in the same manner and subject to the same provisions and limitations as in the case of a deficiency in a tax imposed by this title: * * *
>
> (1) Transferees—The liability at law or in equity of a transferee of property of a taxpayer, in respect to the tax, (including interest, additional amounts and additions to the tax imposed upon the taxpayer by this title)."

The stockholders who received all the taxable income of the Royal Mineral Association for 1937 received it subject to something "in the nature of an equitable lien" in favor of the Government for the accrued and unpaid Federal income tax thereon. *In re Brezin,* 297 Fed. 300; *U. S. vs. McHatton,* 266 Fed. 602.

The corporate distributions, to the extent of such tax, never became the absolute property of the stockholders free from lien until the 1937 Federal income tax thereon was paid.

No one would question the right of the Commissioner to enjoin such distribution by the Royal Mineral Association of all its taxable income for 1937 if it appeared that there would be no property left with which to pay accrued income taxes thereon. No one will deny that if the Royal Mineral Association had disbursed all such income and had no property or income remaining with which to pay the Federal income tax thereon, the Commissioner himself could have successfully maintained action against the stockholders to recover the tax; *but* we respectfully submit that no one

could deny that any such action on the part of the Commissioner would be entirely inconsistent with his present contention that the entire amount of such distributions received by the stockholders was taxable income to them.

The Royal Mineral Association Having Disbursed All Its Taxable Income for 1937 Without Payment of the Accrued Income Tax Thereon the Amount of That Tax Became a Capital Charge.

It is provided in Section 22 (d) of the Act that "distributions by corporations shall be taxable to the shareholders as provided in Section 115." Section 115 provides generally that the term "dividend" means any distribution made by a corporation to its shareholders out of earnings or profits. If "earnings or profits" were interpreted to mean the taxable earnings or profits of a corporation, and if a corporation disbursed all of such taxable profits each year to its stockholders, there would gradually be a complete distribution of all the capital of the corporation and the shareholders would be required to pay income taxes on the whole thereof. This admittedly was not the intent of Congress. The Commissioner freely admits that stockholders have the right to deduct such corporation Federal income taxes at some time. What Congress did intend was that only so much of the profit of a corporation as remained after deducting Federal income taxes thereon should be considered as income and profits of the stockholders individually when distributed to them. When all the taxable profits of a corporation are distributed to its stockholders, then that part thereof equal to the income tax thereon is a return of capital to the shareholders and not taxable income.

It is only because the Royal Mineral Association had available each year for distribution to its stockholders a substan-

tial amount of depletion that it could disburse its entire taxable earnings. Even then, if it had had heavy creditors, they could have objected to such large distributions. Under the actual circumstances existing there was presented each year to the shareholders the problem of determining how much of the distributions received by them constituted income and how much depletion or return of capital.

Without discussion thereof, we commend to the Court the opinion of the Board of Tax Appeals, as found at page 10 of the Record that to permit a distribution of gross earnings and profits without making allowance for outstanding obligations would leave such obligations a charge on capital regardless of the method by which the corporation keeps its books or reports its income for Federal income tax purposes.

Income Tax Returns on Cash Receipts and Disbursements Basis Often Impossible or Inaccurate.

It was early recognized that it is often impossible for a taxpayer to make a truly satisfactory income tax return on the cash receipts and disbursements basis. For that reason, the law was amended in 1916 to provide for such returns on the accrual basis, and "the return must be filed on the accrual basis" where true income cannot be arrived at on the basis of actual receipts and disbursements. *Aluminum Castings Company vs. Routzahn,* 282 U. S. 92, 51 S. Ct. 11, 74 L. Ed. 601.

4. The Commissioner's Position—Errors Therein.

The Commissioner's only answer to all the foregoing reasons supporting the taxpayers' contention is (quoting from his Brief in the Circuit Court of Appeals):

"In the instant case, there is no question that the

> Royal Mineral Association was on the cash receipts and disbursements basis of accounting. It used this method in arriving at the amount of its net income for 1937, and we submit that the same method should be used in determining the amount of taxable dividends distributed by it."

His theory seems to be that as the corporation may not deduct from its gross income its accrued but unpaid expenses or Federal income tax in determining and returning its own taxable income, neither such corporation nor its stockholders may make such deduction for any purpose or in any computation whatsoever. This, we maintain, is contrary to the conclusion reached in the Fawcus case and other cases, *supra*. He claims that such action on the part of the stockholders would result in some forbidden inconsistency.

We direct the Court's attention to several considerations which we believe the Commissioner ignored in arriving at the above stated conclusions.

The Commissioner apparently ignored the fact that all the statutory provisions and Department regulations above referred to are applicable only as between the Revenue Department and the taxpayer in the determination of the taxpayers' taxable income. Such regulations and statutes have no bearing on the determination of a corporation's net income or profits as between it and its stockholders or the investing public. As between them, accrued income taxes are always considered and deducted in arriving at the corporation's "net income." As applied to this particular case, the statutes and regulations were intended to provide for the determination of the true income of the Royal Mineral Association and for the taxation thereof. They were also intended to provide, as between the Revenue Department and the stockholders as entirely different entities, for the determination and taxation of the true taxable income of such

stockholders. The taxable income of the corporation before deduction of taxes thereon does not represent income of the stockholders, who can receive as true income at most only what is left of the corporation's earnings after the corporation's income tax thereon is deducted.

The computation and return of the corporation's income tax may when accepted by the Department be final and binding as between the Department and the corporation. They are not, however, binding as between the stockholders and the Revenue Department. This is well illustrated by the case of *Wells Fargo Bank & Union Trust Company vs. U. S.*, 78 Fed. (2d) 934. In that case, the Wells Fargo Company was permitted to show, for the purpose of determining its own taxable income, that the corporation had made excessive allowances for depletion, as a result of which a part of the corporate disbursements received by the stockholder under the designation of "dividends" was in fact return of capital. Identically the same rule was followed by the Board of Tax Appeals in the case of *Irving vs. Robeson,* 18 B. T. A. 323.

It is true that if a taxpayer adopts either the cash or the accrual basis for determining and returning his income and taxes thereon, he must be consistent and if he adopts the accrual basis, he must include all accrued but uncollected earnings as well as accrued but unpaid expenses. The cases are unanimous on this point. When the word "accrued" is used in this connection, the meaning is accrued or incurred in fact, regardless of book entries. No taxpayer, for instance, on the accrual basis can avoid reporting as income earnings and accounts payable merely because they have not been entered on his books. *Mitchell vs. U. S.*, 271 U. S. 9, 46 S. Ct. 418, 70 L. Ed. 799; *U. S. vs. Anderson, supra; Niles Bement Pond Company vs. U. S.*, 281 U. S. 357, 50 S. Ct. 251, 74 L. Ed. 901; Article 115-3, Income Tax Regulations 94, *supra.*

Of course, it is a fact that it may not be possible for every corporation to determine at the end of the calendar or fiscal year just exactly what its Federal income tax will be, and such tax has not yet been formally levied, and under such circumstances, cannot be entered on the books before the close of the year. Nevertheless, it has been held by this Court that when such tax is finally determined it may be accrued on the books as of the year involved. *Aluminum Castings Company vs. Routzahn, supra.* This is impliedly admitted by the Commissioner in his admission that if the Royal Mineral Association had been on the accrual basis the taxpayers' theory would have been proper in this case.

The Commissioner overlooks the fact that there is nothing in the statutes or regulations which requires one taxpayer to make his income tax returns on either the cash or the accrual basis merely because some other taxpayer makes its returns on that basis. Every taxpayer has a right under the statutes to select his own method of computing and returning his taxable income, provided only such method properly used is sufficient to determine his true income for taxation purposes. As we have seen, not even the corporation's return of its own taxable income is binding on the stockholders. Moreover, the obligation to pay the accrued Federal income tax on such corporate income is that of the corporation itself and not the stockholders. Some stockholders are doubtless on the accrual basis and some on the cash basis. Yet, no one will contend that if a stockholder were on the accrual basis, he should be permitted to deduct the corporation's Federal income tax while the same privilege should be denied to a stockholder on the cash basis.

Corporations Never Deduct Their Own Federal Income Taxes in Determining Their Own Income.

The Commissioner ignores the fact that so far as Federal income taxes are concerned, it makes no difference whatsoever in the computation of the taxable income of a corporation whether it computes and returns its taxable income on the cash or on the accrual basis. A corporation never deducts Federal income taxes in computing its taxable income. Such taxes are never treated as an expense such as cost of labor or material in computing income either on the cash or accrual basis. Section 23 of the Act provides in part:

> "In computing net income there shall be allowed as a deduction * * *
>
> (c) Taxes Generally—Taxes paid or accrued within the taxable year *except* (1) *Federal income,* war profits and excess profits taxes." (Italics ours.)

So the Royal Mineral Association, in computing its taxable income, deducted neither the accrued income tax thereon for the year 1937, nor that for the year 1936 paid in 1937. Under these circumstances, if the Commissioner carried his argument to its logical conclusion that the stockholder must follow the same method as the corporation, he would be forced into the position that as the Royal Mineral Association did not deduct any Federal income tax in making its own return, it follows that the stockholder cannot deduct any such taxes. As we have seen, however, he necessarily and freely concedes that such a conclusion would be inaccurate and contrary to the intent of the statutes and regulations, when he admits that the petitioners may deduct the 1936 income tax paid by the corporation in 1937. As a corporation never deducts its income tax in computing its own taxable income, the question of when such tax may be deducted in computing the income of the stockholders is one

arising and existing solely between the Revenue Department and them, and we respectfully submit there is no logical reason for making the answer to that question depend on whether the corporation makes its returns on the cash or on the accrual basis.

Moreover, the treatment of income taxes of a corporation differs from the determination and treatment of the income tax of the stockholders in other respects. For instance, in said Article 115-3, Regulations 94, promulgated under the Act of 1936, it is provided:

> "Among the items entering into the computation of corporate earnings or profits for a particular period are all income exempted by statute, income not taxable by the Federal Government under the Constitution, as well as all items includible in gross income under section 22 (a) of the Act or corresponding provisions of prior Acts. Gains and losses within the purview of section 112 or corresponding provisions of prior Acts are brought into the earnings and profits at the time and to the extent such gains and losses are recognized under that section. *Interest on State bonds and certain other obligations, although not taxable when received by a corporation, is taxable to the same extent as other dividends when distributed to shareholders in the form of dividends.*" (Italics ours.)

5. Discussion of the Opinion of the Lower Court.

The lower Court apparently found other reasons besides the mere fact that the Royal Mineral Association was on the cash basis for reversing the Board of Tax Appeals, and we wish to discuss some features of that opinion, in which we respectfully contend the Court fell into grievous errors.

The Court said:

> "The contention of the taxpayer, sustained by the decision of the Board, imputes to Congress an intent to exempt from taxation dividends paid to stockholders from current earnings or profits during a taxable year

> to the extent that the tax on the corporation's income for the taxable year *exceeds* its income tax for the preceding year, unless at the close of the taxable year the corporation has an earned surplus or a reserve sufficient to pay such taxes when levied and payable in the succeeding year. For, applying the rule to stockholders in a corporation on a cash basis whose income tax varies in amount from year to year, the excess of income tax on the corporation's income in one year over its income tax in the preceding year will be exempt to the stockholders from income taxes to the extent of such excess."

We respectfully submit that statement to be grossly involved and misleading. The taxpayers' claim does not in any way involve any consideration of any income tax for the preceding year. The taxpayers' contention simply is that from the taxable income of the corporation for any year when all such income is distributed to its stockholders must be deducted the income tax accrued thereon in order to determine how much of those distributions received by the stockholders constitutes income to them. The Commissioner's claim is equally simple. It is that instead of deducting accrued Federal income tax on the income for the year in question, the stockholders can only deduct the tax paid during that year on the corporation's taxable income for the previous year. The lower Court would make the petitioners' claim appear complicated and involved instead of simple and clear, as it really is.

The lower Court has in some way confused the two claims. Possibly it has overlooked the fact that the instant case is complicated by the Commissioner's proposed change of methods and the fact that he offers to permit the stockholders to deduct from the taxable income of the corporation in 1937 its 1936 income tax paid in 1937, notwithstanding the fact that the stockholders, in accordance with their customary practice, have already deducted such 1936 income

tax in returning their own income for that year and make no affirmative claim to the benefit of the 1936 tax deduction offered by the Commissioner. Incidentally, if the Commissioner's new method be sustained by this Court, he will naturally claim that the stockholders' return for the year 1936 was erroneous because of the fact that they had deducted the amount of the 1936 income taxes of the corporation, which they had no right to deduct until 1937. In such event, he would naturally make a deficiency levy and undertake to collect it, provided only the 1936 income tax of the corporation was larger than its 1935 income tax. The Commissioner would thus continue to levy deficiency taxes for as many years back as permissible under the statute of limitations.

The Court says:

> "In the instant case, the difference between $92,552.88 and $30,606.76, or $61,946.12 of the earnings distributed by the corporation in 1937, although actually received by the stockholders during the taxable year, would be exempt from Federal income taxes."

We claim that not only the $61,946.12 but the entire $92,552.88 is exempt from Federal taxation against the stockholders. The Commissioner admits the accuracy of that claim. The only difference between us is as to the year in which such $92,552.88 may be deducted by the stockholders from their corporate distributions received.

The Court said:

> "The taxpayer's theory grafts upon the statute a condition or limitation based upon the assumption that Congress in providing that a taxable dividend 'means any distribution made by the corporation to its stockholders * * * out of the earnings or profits of the taxable year' implied the condition: 'if there are such earnings or profits remaining after deducting federal taxes for the taxable year.' To read into the statute

> such an implied condition is equivalent to amending it; and neither the Board nor this court can so amend the Act. Congress alone has power to do so."

In making that statement, the Court demonstrated that it failed to differentiate between corporate distributions received by a stockholder and income received by him. The Court has apparently adopted the theory that all taxable income of the corporation distributed to a stockholder is income to him. The Court refers to the "implied condition: *if there are such earnings or profits* remaining after deducting federal taxes for the taxable year." The Court suggests the idea that all of the corporation's earnings for any year might be consumed in income taxes thereon, a contingency of course not possible under any heretofore existing income tax laws.

The Court further said:

> "It was not the purpose of the Act to permit gross income actually received by the stockholder to be diminished by taxes neither accrued nor paid by the corporation in the taxable year, even though imposed upon the earnings of that year."

We do not have here any question as to deductions from gross income received by a stockholder. We do have a question of what constitutes gross income received by a stockholder, and in the foregoing statement the Court begs the question by assuming all corporate distributions received by him to be gross income.

The Court says:

> "The Board, in its opinion, reads into this statutory definition of 'dividend,' the general law relating to the right of a corporation to declare dividend. Section 115 (a) does not refer to the power of the corporation to distribute its earnings to its stockholders; that section relates only to what the stockholder must include in his 'gross' income."

We understand the Board refers to the general law only for the purpose of determining what are "earnings" and "profits" within the meaning of Section 115 (a) which the shareholder must include in his gross income. Such meaning must be ascertained from a consideration of general law and general understanding. The statute does not define the words.

The Court finally says:

> "The purpose of the Revenue Act of 1936 was to require returns that clearly reflect taxable income * * *. The purpose of the Act can be accomplished in such a case, only by using the method of computation followed by the commissioner in this instance."

Surely grave doubt upon the accuracy of that conclusion must arise from the fact that stockholders of the Royal Mineral Association used the exact method of computation advocated by these taxpayers for twenty years without protest, and that it was not until the year 1937, so far as such stockholders were concerned at least, when the Commissioner adopted his new theory with the result of imposing upon these taxpayers heavy additional tax. If the Court's conclusion was correct, it would seem that the Commissioner might have discovered that fact before 1931 and might have asked for a review of the Hadden case. If the method advocated by these taxpayers were complicated and involved, as the lower Court seems, from its statement first above quoted, to assume, there might be a justification for the Court's conclusion; but simple as the petitioners' theory is, it suggests to us no difficulty whatsoever in its application.

CONCLUSION

We respectfully submit that the Writ should be granted and the decision of the lower Court should be reviewed, to the end that it may be reversed and the proper rule laid down for application uniformly throughout the country.

All of which is respectfully submitted,

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APPENDIX

Revenue Act of 1936, c. 690, 49 Stat. 1648:

SEC. 41. GENERAL RULE.

The net income shall be computed upon the basis of the taxpayer's annual accounting period (fiscal year or calendar year, as the case may be) in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but if no such method of accounting has been so employed, or if the method employed does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of the Commissioner does clearly reflect the income. * * *

SEC. 43. PERIOD FOR WHICH DEDUCTIONS AND CREDITS TAKEN.

The deductions and credits (other than the dividends paid credit provided in section 27) provided for in this title shall be taken for the taxable year in which "paid or accrued" or "paid or incurred," dependent upon the method of accounting upon the basis of which the net income is computed, unless in order to clearly reflect the income the deductions or credits should be taken as of a different period. * * *

SEC. 115. DISTRIBUTIONS BY CORPORATIONS.

(a) *Definition of Dividend.*—The term "dividend" when used in this title (except in section 203 (a) (3) and section 207 (c) (1), relating to insurance companies) means any distribution made by a corporation to its shareholders, whether in money or in other property, (1) out of its earnings or profits accumulated after February 28, 1913, or (2) out of the earnings or profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made.

(b) *Source of Distributions.*—For the purposes of this Act every distribution is made out of earnings or

profits to the extent thereof, and from the most recently accumulated earnings or profits. * * *

* * * * * * * * * *

Treasury Regulations, 94, promulgated under the Revenue Act of 1936.

ART. 41-1. *Computation of net income.*—Net income must be computed with respect to a fixed period. Usually that period is 12 months and is known as the taxable year. * * * The time as of which any item of gross income or any deduction is to be accounted for must be determined in the light of the fundamental rule that the computation shall be made in such a manner as clearly reflects the taxpayer's income. If the method of accounting regularly employed by him in keeping his books clearly reflects his income, it is to be followed with respect to the time as of which items of gross income and deductions are to be accounted for. (See articles 42-1 to 42-3.) If the taxpayer does not regularly employ a method of accounting which clearly reflects his income, the computation shall be made in such manner as in the opinion of the Commissioner clearly reflects it.

ART. 41-2. *Bases of computation and changes in accounting methods.*—Approved standard methods of accounting will ordinarily be regarded as clearly reflecting income. A method of accounting will not, however, be regarded as clearly reflecting income unless all items of gross income and all deductions are treated with reasonable consistency. * * *

* * * * * * * * * *

ART. 43-1. *"Paid or incurred" and "paid or accrued"* —(*a*) The terms "paid or incurred" and "paid or accrued" will be construed according to the method of accounting upon the basis of which the net income is computed by the taxpayer. (See section 48 (c).) The deductions and credits provided for in Title I (other than the dividends paid credit provided in section 27) must be taken for the taxable year in which "paid or accrued" or "paid or incurred," unless in order clearly to

reflect the income such deductions or credits should be taken as of a different period. * * *

* * * * * * * * * *

ART. 43-2. *When charges deductible.*—Each year's return, so far as practicable, both as to gross income and deductions therefrom, should be complete in itself, and taxpayers are expected to make every reasonable effort to ascertain the facts necessary to make a correct return. The expenses, liabilities, or deficit of one year can not be used to reduce the income of a subsequent year. * * *

ART. 115-1. *Dividends.*—The term "dividend" for the purpose of Title I (except when used in sections 203 (a) (3) and 207 (c) (1) thereof) comprises any distribution in the ordinary course of business, even though extraordinary in amount, made by a domestic or foreign corporation to its shareholders out of either.

(1) earnings or profits accumulated since February 28, 1913, or

(2) earnings or profits of the taxable year computed without regard to the amount of the earnings or profits (whether of such year or accumulated since February 28, 1913) at the time the distribution was made.

The earnings or profits of the taxable year shall be computed as of the close of such year, without diminution by reason of any distributions made during the taxable year. For the purpose of determining whether a distribution constitutes a dividend, it is unnecessary to ascertain the amount of the earnings and profits accumulated since February 28, 1913, if the earnings and profits of the taxable year are equal to or in excess of the total amount of the distributions made within such year.

A taxable distribution made by a corporation to its shareholders shall be included in the gross income of the distributees when the cash or other property is unqualifiedly made subject to their demands.

* * * * * * * * * *

ART. 115-2. *Sources of distributions in general.*—

* * *

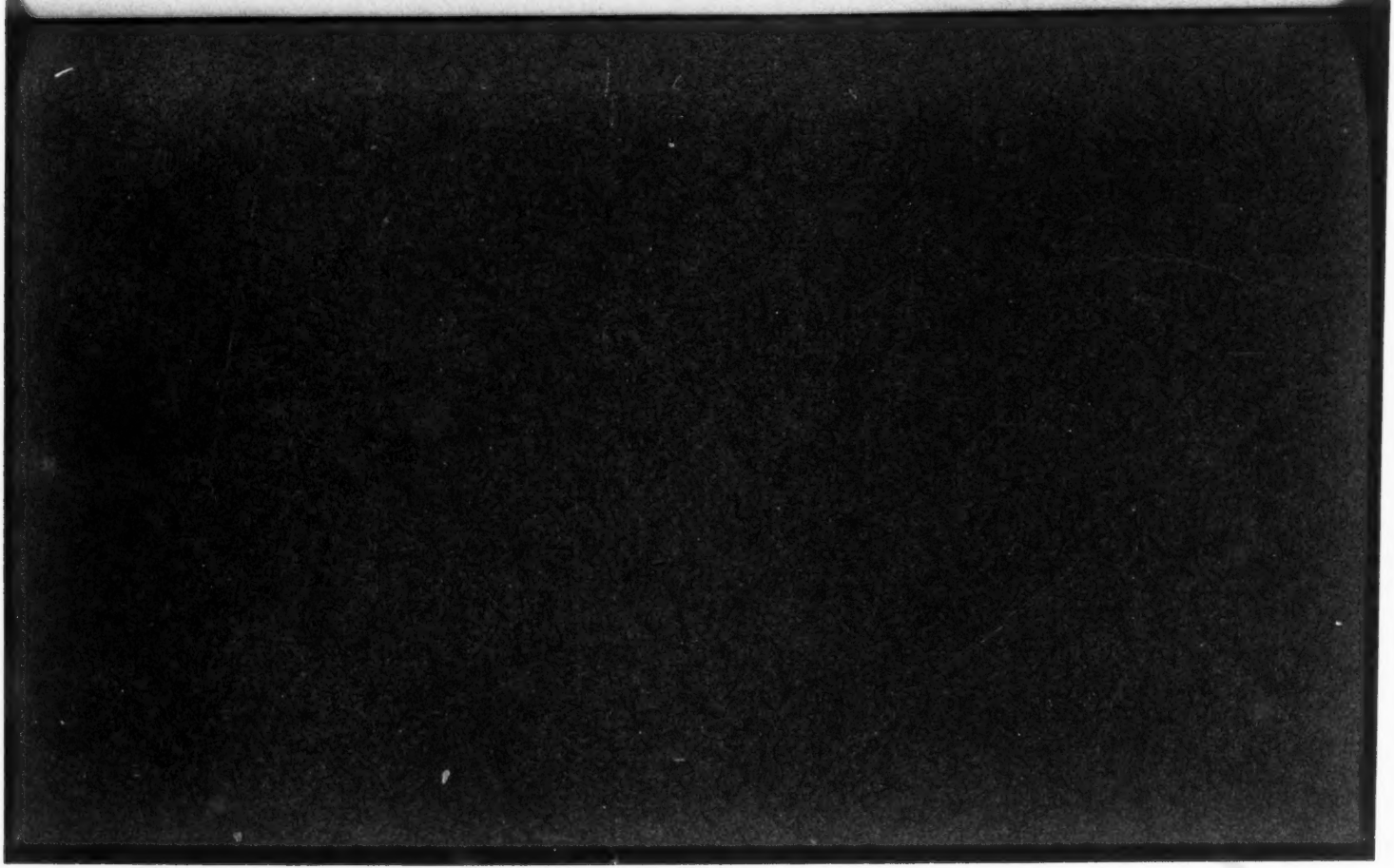
If the earnings or profits of the taxable year (com-

puted as of the close of the year without diminution by reason of any distributions made during the year and without regard to the amount of earnings or profits at the time of the distribution) are sufficient in amount to cover all the distributions made during that year, then each distribution is a taxable dividend. (See article 115-1.) If the distributions made during the taxable year exceed the earnings or profits of such year, then that proportion of each distribution which the total of the earnings or profits of the year bears to the total distributions made during the year shall be regarded as out of the earnings or profits of that year. * * *

* * * * * * * * * *

ART. 115-3. *Earnings or profits.*—In determining the amount of earnings or profits (whether of the taxable year, or accumulated since February 28, 1913, or accumulated prior to March 1, 1913) due consideration must be given to the facts, and mere bookkeeping entries increasing or decreasing surplus will not be conclusive. Among the items entering into the computation of corporate earnings or profits for a particular period are all income exempted by statute, income not taxable by the Federal Government under the Constitution, as well as all items includible in gross income under section 22 (a) of the Act or corresponding provisions of prior Acts. Gains and losses within the purview of section 112 or corresponding provisions of prior Acts are brought into the earnings and profits at the time and to the extent such gains and losses are recognized under that section. Interest on State bonds and certain other obligations, although not taxable when received by a corporation, is taxable to the same extent as other dividends when distributed to shareholders in the form of dividends.

* * * * * * * * * *



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In the Supreme Court of the United States

OCTOBER TERM, 1943

No. 416

M. H. ALWORTH TRUST, M. W. ALWORTH AND R. D. ALWORTH, TRUSTEES, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE EIGHTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The opinion of the Board of Tax Appeals (R. 9–14) is reported at 46 B. T. A. 1045. The opinion of the Circuit Court of Appeals (R. 24–28) is reported at 136 F. 2d 812.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered July 12, 1943 (R. 29). Petition for a writ of certiorari was filed October 8, 1943. The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code (28 U. S. C. 1940 ed., Sec 347), as amended by the Act of February 13, 1925.

QUESTION PRESENTED

In determining the earnings or profits of a corporation available for dividends under Section 115 (a) of the Revenue Act of 1936, where it is on the cash basis, should there be deducted the income and excess profits taxes paid during the year, as held by the court below, or those accruing during the year but not paid until the following year, as contended by the taxpayer?

STATUTE AND REGULATIONS INVOLVED

The statute and regulations involved are set forth in the Appendix, *infra,* pp. 10–15.

STATEMENT

The facts are not in dispute and are as follows:

Petitioners are the trustees of a testamentary trust created under the will of M. H. Alworth, deceased. During the year 1937 they were the owners of three-tenths of the outstanding stock of the Royal Mineral Association, a Minnesota corporation, which stock had passed to them under the decedent's will. (R. 10.)

The Royal Mineral Association was organized about 1909 and throughout its existence owned certain mineral interests on Mesaba Range in Minnesota. It was liquidated and dissolved toward the end of 1939. In each year of its existence it distributed to its stockholders all of its net earnings for the year and substantial amounts from depletion reserves. As a consequence it never, from one year to the next, had an earned surplus. In 1917 and each year thereafter the net income of the corporation, less the federal income

and excess profits taxes accruing for such year, was regarded as the portion of the distribution which constituted dividends, the remainder being regarded as a distribution of capital (i. e., as a distribution out of depletion reserves). (R. 10.)

The corporation's taxable net income for 1937 was $464,033.94 on which the federal income tax was $92,552.88, all paid in 1938. During 1937 the Association paid federal income tax in the amount of $30,606.76 on its income for 1936. In computing the amount of the corporation's 1937 earnings or profits available for distribution, the corporation and the petitioners, in accordance with their prior practice, deducted from the corporation's taxable net income of $464,033.94 the $92,552.88 of income tax payable thereon and arrived at $371,481.06 as the amount available for such distribution. In determining the deficiency due from the petitioners, as trustees, the Commissioner deducted from the corporation's net income of $464,033.94 the amount of $30,606.76 representing the income tax which the corporation paid during 1937 on 1936 income, and thereby determined that $433,427.18 was available for distribution as dividends. (R. 10.)

During 1937 the trustees received distributions in the sum of $218,070 from the Royal Mineral Association. Under the method which they used in computing the amount of earnings or profits of the Association available for dividends, the trustees ascertained that $111,444.24 of the $218,070 they had received constituted taxable dividends and accordingly the trustees reported the $111,444.24 as taxable dividends in

the income tax return of the trust for 1937. Under the method which he used, the Commissioner determined that $130,028.60 of the $218,070 constituted taxable dividends and increased the amount which the trustees had received from that source by $18,584.36. (R. 10–11.)

The Royal Mineral Association always filed its income tax returns on the cash receipts and disbursements basis (R. 11).

The Board of Tax Appeals sustained the contention of the petitioners (R. 9–14). The Circuit Court of Appeals reversed the Board of Tax Appeals and affirmed the determination of the Commissioner (R. 23–28).

ARGUMENT

The decision below is correct and presents no conflict. There is no occasion for further review.

Superficially there may appear to be a conflict between the decision below and *Hadden* v. *Commissioner,* 49 F. 2d 709 (C. C. A. 2d), but actually there is none due to the essential difference between the statutes respectively involved. The statute in the *Hadden* case (Section 31 (a), Revenue Act of 1916, c. 463, 39 Stat. 756, as added by Section 1211 of the Revenue Act of October 3, 1917, c. 63, 40 Stat. 300) reads as follows:

> SEC. 31. (a) That the term "dividends" as used in this title shall be held to mean any distribution made or ordered to be made by a corporation, joint-stock company, association, or insurance company, out of its earnings or profits *accrued since* March first, nineteen hun-

> dred and thirteen, and payable to its shareholders, whether in cash or in stock of the corporation, joint-stock company, association, or insurance company, which stock dividend shall be considered income, to the amount of the earnings or profits so distributed. [Italics ours.]

Thus the statute involved in the *Hadden* case specified accrued earnings or profits, i. e., "earnings or profits accrued since" March 1, 1913. A dividend from "earnings or profits accrued" after the critical date was subjected to tax. It was, accordingly, arguable that under such a statute the corporation would not have "earnings or profits accrued" unless its accrued taxes were taken into account. Moreover, under the Act of 1916 it was necessary to determine the earnings of the corporation for the portion of the taxable year to the date of distribution, and the Commissioner's defense was concentrated upon the sole issue that the taxes were unknown at the distribution date and would not accrue until the end of the year. As a result the court had no occasion to consider whether a different rule should be applied where the corporation was on the cash basis.[1]

The term "dividend" is used in the Revenue Act of 1936 (Section 115, Appendix, *infra*) in a less restricted sense. It is defined there as meaning any corporate

[1] The corporation whose dividends were under consideration in *Commissioner* v. *James*, 49 F. 2d 707 (C. C. A. 2d), kept its books and made its returns upon the accrual basis. Thus obviously its "earnings or profits" had to be determined by the accrual method. The court said (p. 708): "The tax does not stand on any different footing from other accrued expenses appearing on the * * * [corporation's] books."

distribution (1) out of earnings or profits *accumulated*[2] after February 28, 1913, or, (2) out of earnings or profits for the taxable year. Such a provision in no way implies that earnings and profits shall be determined upon the accrual basis rather than upon the cash basis where the latter is the corporation's method of keeping its accounts and making its income tax returns.

The corporation whose earnings and profits are involved here always filed its income tax returns on the cash receipts and disbursements basis (R. 11) and there is no question that it was on that basis of accounting. The suggestion of the petitioners (Br. 21) that every person has the right to select his own method of computing the amount of earnings and profits *of corporations* in which he is a stockholder, is not worthy of serious consideration.

The decision below preserves the well established distinction between the cash and the accrual methods of corporate accounting. Petitioners on the other hand, in ultimate analysis, contend that all items of gross income, and all deduction items *but one,* which enter into the determination of the "earnings or profits" of the Royal Mineral Association for the tax year, should be determined upon the cash basis. Thus they contend for the determination of corporate "earn-

[2] All Revenue Acts since 1916 have used the term "accumulated" instead of "accrued." See, for example, Section 201 of the Revenue Act of 1918, c. 18, 40 Stat. 1057.

ings or profits" upon a hybrid basis, predominantly cash but as to one item, accrual.[3]

The decision below accords with the decision of this Court in *United States* v. *Mitchell,* 271 U. S. 9. There the Court held that where the accounts of an estate were kept on the basis of actual receipts and disbursements the executors could not deduct from the income of the taxable year the estate tax which had accrued during the year but was not paid until later. In so holding the Court said (pp. 12–13):

> Assuming, as we must, that the accounts of the estate were kept on the basis of actual receipts and disbursements, the executors were required to make return on that basis. Notwithstanding the option given taxpayers, it is the purpose of the Act to require returns that clearly reflect taxable income. That purpose will not be accomplished unless income received and deductible disbursements made are treated consistently. It was not the purpose of the Act to permit gross income actually received to be diminished by taxes or other deductible items disbursed

[3] If the one departure from the cash basis be permitted the exception conceivably may destroy the general rule, with the result that all other accrued liabilities and all accrued income items would have to be taken into account in determining the "earnings or profits" of a *cash basis* corporation. Cf. *Niles Bement Pond Co.* v. *United States,* 281 U. S. 357, where the corporation was on the accrual basis and this Court held (p. 360) that the corporate deduction for foreign taxes must be "accrued so as to reflect true income by conforming to the *dominating or controlling character of the taxpayer's system of accounts.*" [Italics ours.]

> in a later year, even if accrued in the taxable year. It is a reasonable construction of the law that the same method be applied to both sides of the account.

There is no conflict with *Fawcus Machine Co.* v. *United States,* 282 U. S. 375, for the question there concerned invested capital and in any event the corporation was on the accrual basis. Nor do the regulations which the Commissioner issued even under the earliest acts support the petitioners' argument. True, Article 1542 of Treasury Regulations 62, promulgated under the Revenue Act of 1921, reads in part as quoted in petitioners' brief (p. 12). Compare Article 1542, Treasury Regulations 45, promulgated under the Revenue Act of 1918. But that article [4] must be read in the light of G. C. M. 2951, VII–1 Cum. Bull. 160 (1928), which interprets the article and holds (p. 161):

> A corporation whose books of account are on the cash receipts and disbursements basis can only ascertain its earnings and profits by treating as gross income all items of income when received and deducting items of expense when paid.

The Bureau of Internal Revenue has adhered to this view. See I. T. 3253, 1939–1 Cum. Bull. 178; T. D. 5059, 1941–2 Cum. Bull. 125.

Thus it can be categorically stated that the decision of the Board was contrary to the practice of the Bureau, while the decision of the Circuit Court of

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[4] The particular provision which petitioners quote has never appeared in any subsequent regulations.

Appeals is in accord with the Bureau practice. The fact, if it be a fact, that in prior years the Commissioner may have permitted stockholders of the corporation to account for the distributions which they received on the basis for which petitioners argue is quite immaterial.[5]

CONCLUSION

The petition for certiorari should be denied.

Respectfully submitted.

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SAMUEL O. CLARK, Jr.,
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SEWALL KEY,
HELEN R. CARLOSS,
WARREN F. WATTLES,
Special Assistants to the Attorney General.

OCTOBER 1943.

[5] The United States is not bound by the mistakes of its agents (*Utah Power & Light Co.* v. *United States*, 243 U. S. 389, 408–409) and no estoppel arises out of the Commissioner having accepted incorrect returns for prior years (*Detroit & Windsor Ferry Co.* v. *Woodworth*, 115 F. 2d 795, 798 (C. C. A. 6th), certiorari denied, 312 U. S. 692; *J. C. Nichols Land Co.* v. *Commissioner*, 65 F. 2d 437, 438 (C. C. A. 8th)).

APPENDIX

Revenue Act of 1936, c. 690, 49 Stat. 1648:

SEC. 41. GENERAL RULE.

The net income shall be computed upon the basis of the taxpayer's annual accounting period (fiscal year or calendar year, as the case may be) in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but if no such method of accounting has been so employed, or if the method employed does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of the Commissioner does clearly reflect the income. * * *

SEC. 43. PERIOD FOR WHICH DEDUCTIONS AND CREDITS TAKEN.

The deductions and credits (other than the dividends paid credit provided in section 27) provided for in this title shall be taken for the taxable year in which "paid or accrued" or "paid or incurred", dependent upon the method of accounting upon the basis of which the net income is computed, unless in order to clearly reflect the income the deductions or credits should be taken as of a different period. * * *

SEC. 115. DISTRIBUTIONS BY CORPORATIONS.

(a) *Definition of dividend.*—The term "dividend" when used in this title (except in section 203 (a) (3) and section 207 (c) (1), relating to insurance companies) means any distribution made by a corporation to its shareholders, whether in money or in other property, (1) out of its earnings or profits accumulated after February 28, 1913, or (2) out of the earnings or profits of the taxable year (computed as of the close of the taxable year without diminu-

tion by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made.

(b) *Source of distributions.*—For the purposes of this Act every distribution is made out of earnings or profits to the extent thereof, and from the most recently accumulated earnings or profits. Any earnings or profits accumulated, or increase in value of property accrued, before March 1, 1913, may be distributed exempt from tax, after the earnings and profits accumulated after February 28, 1913, have been distributed, but any such tax-free distribution shall be applied against and reduce the adjusted basis of the stock provided in section 113.

* * * * *

Treasury Regulations 94, promulgated under the Revenue Act of 1936:

ART. 41–1. *Computation of net income.*—Net income must be computed with respect to a fixed period. Usually that period is 12 months and is known as the taxable year. * * * The time as of which any item of gross income or any deduction is to be accounted for must be determined in the light of the fundamental rule that the computation shall be made in such a manner as clearly reflects the taxpayer's income. If the method of accounting regularly employed by him in keeping his books clearly reflects his income, it is to be followed with respect to the time as of which items of gross income and deductions are to be accounted for. (See articles 42–1 to 42–3.) If the taxpayer does not regularly employ a method of accounting which clearly reflects his income, the computation shall be made in such manner as in the opinion of the Commissioner clearly reflects it.

ART. 41–2. *Bases of computation and changes in accounting methods.*—Approved standard methods of accounting will ordinarily be regarded as clearly reflecting income. A method of accounting will not, however, be regarded as clearly reflecting income unless all items of gross income and all deductions are treated with reasonable consistency. * * *

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ART. 43–1. *"Paid or incurred" and "paid or accrued."*—(*a*) The terms "paid or incurred" and "paid or accrued" will be construed according to the method of accounting upon the basis of which the net income is computed by the taxpayer. (See section 48 (c).) The deductions and credits provided for in Title I (other than the dividends paid credit provided in section 27) must be taken for the taxable year in which "paid or accrued" or "paid or incurred," unless in order clearly to reflect the income such deductions or credits should be taken as of a different period. If a taxpayer desires to claim a deduction or a credit as of a period other than the period in which it was "paid or accrued" or "paid or incurred," he shall attach to his return a statement setting forth his request for consideration of the case by the Commissioner together with a complete statement of the facts upon which he relies. However, in his income tax return he shall take the deduction or credit only for the taxable period in which it was actually "paid or incurred," or "paid or accrued," as the case may be. Upon the audit of the return, the Commissioner will decide whether the case is within the exception provided by the Act, and the taxpayer will be advised as to the period for which the deduction or credit is properly allowable.

(*b*) The provisions of paragraph (*a*) of this article in general are not applicable with re-

spect to the taxable period during which the taxpayer dies. In such case there shall also be allowed as deductions and credits for such taxable period amounts accrued up to the date of his death if not otherwise allowable with respect to such period or a prior period, regardless of the fact that the decedent was required to keep his books and make his returns on the basis of cash receipts and disbursements.

* * * * *

ART. 115–1. *Dividends.*—The term "dividend" for the purpose of Title I (except when used in sections 203 (a) (3) and 207 (c) (1) thereof) comprises any distribution in the ordinary course of business, even though extraordinary in amount, made by a domestic or foreign corporation to its shareholders out of either

(1) earnings or profits accumulated since February 28, 1913, or

(2) earnings or profits of the taxable year computed without regard to the amount of the earnings or profits (whether of such year or accumulated since February 28, 1913) at the time the distribution was made.

The earnings or profits of the taxable year shall be computed as of the close of such year, without diminution by reason of any distributions made during the taxable year. For the purpose of determining whether a distribution constitutes a dividend, it is unnecessary to ascertain the amount of the earnings and profits accumulated since February 28, 1913, if the earnings and profits of the taxable year are equal to or in excess of the total amount of the distributions made within such year.

A taxable distribution made by a corporation to its shareholders shall be included in the gross income of the distributees when the cash or other property is unqualifiedly made subject to their demands.

* * * * *

ART. 115–2. *Sources of distributions in general.*—For the purpose of income taxation every distribution made by a corporation is made out of earnings or profits to the extent thereof and from the most recently accumulated earnings or profits. In determining the source of a distribution, consideration should be given *first,* to the earnings or profits of the taxable year; *second,* to the earnings or profits accumulated since February 28, 1913, only in the case where, and to the extent that, the distributions made during the taxable year are not regarded as out of the earnings or profits of that year; *third,* to the earnings or profits accumulated prior to March 1, 1913, only after all the earnings or profits of the taxable year and all the earnings or profits accumulated since February 28, 1913, have been distributed; and, *fourth,* to sources other than earnings or profits only after the earnings or profits have been distributed.

If the earnings or profits of the taxable year (computed as of the close of the year without diminution by reason of any distributions made during the year and without regard to the amount of earnings or profits at the time of the distribution) are sufficient in amount to cover all the distributions made during that year, then each distribution is a taxable dividend. (See article 115–1.) If the distributions made during the taxable year exceed the earnings or profits of such year, then that proportion of each distribution which the total of the earnings or profits of the year bears to the total distributions made during the year shall be regarded as out of the earnings or profits of that year. * * *

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ART. 115–3. *Earnings or profits.*—In determining the amount of earnings or profits (whether of the taxable year, or accumulated since February 28, 1913, or accumulated prior

to March 1, 1913) due consideration must be given to the facts, and mere bookkeeping entries increasing or decreasing surplus will not be conclusive. Among the items entering into the computation of corporate earnings or profits for a particular period are all income exempted by statute, income not taxable by the Federal Government under the Constitution, as well as all items includible in gross income under section 22 (a) of the Act or corresponding provisions of prior Acts. Gains and losses within the purview of section 112 or corresponding provisions of prior Acts are brought into the earnings and profits at the time and to the extent such gains and losses are recognized under that section. Interest on State bonds and certain other obligations, although not taxable when received by a corporation, is taxable to the same extent as other dividends when distributed to shareholders in the form of dividends.

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